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The Manufacturers Hanover
Financial Digest
Weekly Commentary, Selected Financial Data, and Business Indicators

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Strengthening Business Activity . . .

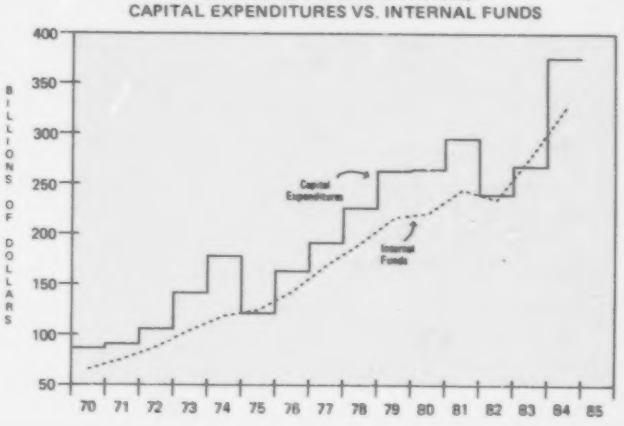
Despite the welcome interest rate relief provided by last summer's business pause, the New Year may well bring something quite different to the credit markets—higher interest rates. This is because with economic activity already picking up, household and business borrowings are sure to follow. Add to this the apparently insatiable credit appetite of the Federal government and the stage is set for a reversal of last year's slide in interest rates. But it is too soon to suggest that such a development will lead to this economy's ninth postwar recession. More than likely, it could produce another growth pause late this year or in 1986 unless a credible Federal deficit reduction program is put into place by the policy-makers in Washington.

Perhaps the most important factor in this year's interest rate outlook is the rate of growth of private credit demands. Fueled by a strong upturn in household and business borrowings used to finance everything from new homes for consumers to new plant and equipment for business, private non-financial credit demands advanced at an almost 12 percent annual rate in the first half of last year, before slumping sharply in the third quarter as the pace of business slowed. In fact, with consumers scaling back both their mortgage and installment debt acquisitions, while businesses hurried to pare inventories, private sector borrowings actually declined by 16 percent quarter-over-quarter. What is more, when expressed as a percentage of gross national product, such borrowings fell to their lowest level in a year—also a period of falling, rather than rising interest rates. This development, together with stepped-up Federal Reserve efforts to restart both the economy and money supply growth, provided the one-two punch necessary to flatten interest rates last autumn.

. . . And Rising Credit Demands . . .

But as these factors begin to reverse themselves, prospects for interest rates remaining down begin to dim. Take, for example, the economy. With the index of leading economic indicators, retail sales, factory orders and construction spending all pointing toward faster, rather than slower growth, talk of a so-called "growth recession" has diminished. So, too, recent money supply and bank loan numbers are also beginning to signal gathering business strength, not additional weakness. After lying dormant all summer long, money supply growth, particularly that of M2, is accelerating, while bank loan demand has also begun to rebound in recent weeks.

NONFINANCIAL CORPORATIONS:
CAPITAL EXPENDITURES VS. INTERNAL FUNDS



In fact, bank loan demand could continue at a brisk clip not only in the near term, but throughout a sizable part of 1985. This is because as household spending for automobiles and housing perks up, the volume of auto loans and mortgage originations will do so as well—a portion of which will be booked by commercial banks. What is more, with capital spending slated to post another good-sized rise in 1985, while the growth of internal cash flow levels off from its early 1984 high-water mark (when it was running at an annual rate of nine percent of GNP), it appears a good bet that the business financing shortfall will widen throughout much of this year. Even now, business spending for inventories, plant and equipment is running some 19 percent ahead of internal cash generation, one of the widest margins ever recorded at this stage of the business cycle in the past (see chart above).

To be sure, new equity issuance will probably satisfy a larger chunk of business financing needs this year than in 1984—when retirements due to merger and acquisition activity far outran new offerings. However, the bulk of the widening corporate deficit will

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have to be met in the debt markets either here or abroad, a development which not only suggests rising levels of activity at the nation's commercial banks, the commercial paper market and the bond markets—but upward pressures on interest rates as well.

. . . Spell Higher Interest Rates

An upturn in private credit demands at this stage of the business cycle is hardly unusual. In fact, during the third year of those postwar recoveries which lasted that long, private credit demands surged by as much as 45 percent when compared with year-earlier levels. Not surprisingly, interest rates, too, have usually risen at this stage of the business cycle. But what is unusual this time around is that despite the ongoing business expansion and record numbers of people employed, Washington's red-ink total is widening again, suggesting that the abnormally large Federal borrowing requirement will become even larger.

For one thing, whereas the stronger pace of business activity in fiscal year 1984 did manage to shave $20 billion from fiscal 1983's record $195 billion red-ink total, slower growth so far in this fiscal year (which began October 1) has already begun to do the opposite. This, together with rising interest costs and accelerated defense spending, could widen Washing-

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

Reserve Bank Credit	Week Ending 12/26/84	$ Change Since Week Ago	$ Change Since Year Ago
U.S. Gov't and Agencies Owned Outright & RPs	169.224	+ 2.316	+ 9.081
Loans to Depository Inst.	1.844	– 1.317	+ 1.091
Float	1.208	– .123	– 2.384
Total Reserve Bank Credit	184.020	+ 1.337	+11.054
Treasury Deposits with Federal Reserve Banks	3.669	+ .201	– .060
Currency in Circulation	182.790	+ 1.398	+11.183
Gov't's held for Foreign Acct. by F.R. Banks (End-of-Week)	121.322	+ .161	+ 8.476
	12/19/84		
Member Bank Reserves:			
Total Reserves Held	39.574	+ .621	+ 2.136
Excess (Deficiency)	.478	– .429	– .167
Net Borrowed Reserves	.072	+ .502	– .241
		% Change Since	
Monetary Aggregates †		Three Months Ago*	Year Ago
M1 (12/24/84)	557.6	+ 2.3‡	+ 5.1‡
M2 (November '84)	2,346.4	+ 9.7	+ 7.5
M3 (November '84)	2,955.1	+ 11.3	+ 9.9
Domestic Nonfinancial Debt (3rd Q'84)	5,760.0	+ 11.7	+ 12.9

†Seasonally adjusted. * Seasonally adjusted annual rate. ‡ Four-week moving average.

New York Money Market

Offering Rates 1/4/85	3 Months	6 Months	1 Year
‡ U.S. Treasury Bills	7.50%	7.90%	8.10%
* Federal Agencies	8.01	8.65	9.46
* Project Notes—Taxfree (46% Taxable Equivalent)	9.72	10.00	10.37
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	8.23	8.55	9.45

‡ Finance Company Paper—Prime

5- 14 days	8.20%
15- 29 days	8.20
30- 59 days	8.20
60- 89 days	8.20
90-179 days	8.35
180-239 days	8.40
240-270 days	8.40

‡* Bankers' Acceptances

Feb.	8.24%
Mar.	8.24
Apr.	8.30
May	8.35
Jun.	8.40
Jul.	8.35

‡ Industrial Paper—Prime

30- 89 days	8.10%
90-120 days	7.90

†Federal Funds Effective Rate 8.20%

‡Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	3rd Q'84	$ 3,695	$ 3,645	$ 3,347
Gross National Product (1972 Dollars)*	3rd Q'84	$ 1,645	$ 1,639	$ 1,550
Percent Change, Annual Rate	3rd Q'84	1.6	7.1	5.8
Change in Consumer Prices*	Nov '84	2.4%	4.8%	4.8%
Change in Producer Prices*	Nov '84	6.0%	– 2.4%	– 1.2%
Civilian Employment (Thousands of Persons) †	Nov '84	105,872	105,586	102,606
Unemployment as % of Civilian Labor Force †	Nov '84	7.2%	7.4%	8.4%
Personal Income*	Nov '84	$ 3,100	$ 3,079	$ 2,834
Leading Indicators Composite Index (1967=100) †	Nov '84n	166.6	164.5r	162.5
Industrial Production Index (1967=100) †	Nov '84	165.0	164.3	155.3
Net Change in Consumer Installment Credit †	Oct '84	$ 6.28	$ 4.28	$ 5.09
U.S. Merchandise Trade Balance †	Nov '84n	–$ 9.94	–$ 9.18	–$ 7.12
Plant and Equipment Expenditures*	1st Q'85	$337.85(a)	$321.40(a)	$293.15
Private Housing Starts (Thousands of Units)*	Nov '84	1,528	1,538	1,730
New Construction Expenditures*	Nov '84n	$ 322.2	$ 318.8r	$ 267.0
Total Business Inventories †	Oct '84	$ 565.3	$ 560.6	$ 509.2
Total Business Sales †	Oct '84	$ 410.8	$ 410.5	$ 382.5

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. r-Revised. a-Anticipated.

ton's deficit this year by some $15 billion. What is more, beginning this year, indexation of income tax brackets will deprive the Federal government of inflation-driven receipts growth, possibly adding as much as $10 billion or so to the deficit. What all this adds up to is a potential deficit in the neighborhood of $200 billion. If such a deficit does materialize, Washington could absorb as much as 36 percent of all funds raised in the debt markets in 1985—just about three times the proportion usually raised at this stage of the business cycle in the past!

As a result, with household, business and Federal credit needs all poised to move higher due to both higher levels of economic activity and Washington's inability to curb its ongoing financial profligacy, only substantial Federal Reserve accommodation will be able to forestall the anticipated upturn in interest rates. And, with inflation rates still modest and money supply growth well behaved, this cannot be ruled out—at least for a while. But eventually, if the Fed were to accommodate fully competing business, household and Federal borrowings, it would run the risk of reigniting inflation expectations again, and, for this reason, it is an unlikely solution, long-term. That being the case, it is equally unlikely that higher interest rates can be avoided in the new year. H

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Time Deposits of $100,000 or more Weekly Reporting Banks			
Nationwide (12/19/84)	160,646	+ 1,569	+13,877
New York City (12/19/84)	34,553	+ 326	+ 3,470
Commercial Paper (12/19/84)	238,748	+ 309	+55,417

Bank Loans

(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (12/19/84)	250,698	+ 2,206	+ 28,841
New York City (12/19/84)	63,856	+ 722	+ 5,888

Total Loans and Leases Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (12/19/84)	654,678	+ 9,320	+ 104,170
New York City (12/19/84)	149,730	+ 5,246	+ 25,175

Financial Markets

	Friday 1/4/85	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	8.05%	+ .05	– 1.05
180-Day Bills†	8.60	+ .10	– .90
Longest Bills†	9.13	– .02	– .72
Recent Issues:			
9⅞s 12/31/86	10.02	+ .02	
10⅝s 12/31/88	10.86	+ .06	
11⅝s 11/15/94	11.60	+ .15	
11¾s 11/15/14	11.60	+ .15	
Municipals:			
Bond Buyer–20 Bond Index* (1/3/85)	9.87%	– .04	+ .21
Blue List Total ($ Million)	$1,811	– $129	+ $705
30-Day Visible Supply ($ Million)	$2,108	+ $888	– $369
Total	$3,919	+ $759	+ $336
Corporates:			
Moody's Aa Composite (1/3/85)	12.55%	+ .06	– .22
30-Day Visible Supply ($ Million)	$ 350	– $150	– $670
Stocks:			
Dow-Jones Averages:			
Industrials	1,184.96	– 19.21	– 101.79
Transportation	553.03	– 3.88	– 58.76
Utilities	145.54	– .26	+ 11.71
65 Stocks	480.93	– 5.53	– 33.11
Standard and Poor's 500 Stocks	163.68	– 2.58	– 5.60
N.Y.S.E. Composite Index	94.60	– 1.29	– 3.11
N.Y.S.E. Avg. Daily Vol. for Week (000's)	78,610	+16,255	– 42,023

* 46% Taxable equivalent 18.28%.

† Bond equivalent.

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 1/4/85	Week Ago
Overnight	8.19%	8.63%
1 month	8.38	8.38
3 month	8.63	8.63
6 month	9.06	9.13
1 year	9.81	9.81
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	11.40%	11.40%
Long Term (7 to 15 yrs.)	11.70	11.60

FOREIGN EXCHANGE SPOT RATES New York Opening (1/4/85)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.01581	63.27
Canada	.7579	1.3196
Denmark	.08842	11.3100
France	.1034	9.6755
Germany	.3162	3.1625
Italy	.0005141	1945.20
Japan	.003960	252.50
Mexico	.004435	225.50
Netherlands	.2803	3.5678
Switzerland	.3813	2.6223
U.K.	1.1522	.8679

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